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LIST OF AUTHORITIES.

STATUTES.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1924. No. 338.

UNITED STATES, *et al.*, *Appellants,*

v.

BUTTERWORTH JUDSON CORPORATION,
CHASE NATIONAL BANK, *et al.*, *Appellees.*

Appeal from United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR THE UNITED STATES.

This appeal involves the question whether the United States or certain Banks have the better title to $519,631.99 which the United States advanced to the Butterworth-Judson Corporation (hereafter called Butterworth-Judson Co.) under a restrictive written contract as to the application of the money, and which, in strict accordance therewith, the Butterworth-Judson Co. deposited in certain "Special Accounts" in the Banks.

The Banks, with *full knowledge* of the specific contract limitations upon the application of the

money, accepted the deposits with notice that they were deposited to be used for certain specific purposes only; and then they appropriated to their own use the entire deposits in payment of various unsecured debts which the Banks held against the Butterworth-Judson Co., which was *insolvent,* and *went into the hands of Receivers the next day.*

Both the DISTRICT COURT (R. 263-265) and the CIRCUIT COURT OF APPEALS (R. 312-322) held, *first,* that the Banks had the right thus to appropriate, by way of *set-off,* the deposits standing to the Butterworth-Judson's credit, in order to pay *pro tanto* the debts which the Banks held against that company, and *second,* that (*a*) the usual provisions of the United States war-time-contracts for financing munition makers and (*b*) the advance notice to the Banks that the money was deposited for certain specific purposes only, were equally ineffective to preserve to the United States either (1) its prior equitable interest in the funds it so advanced, or (2) the application of such funds to the specific purposes described in its contract of advancement.

The case turns on (1) the legal effect of a customary United States war-time-contract provision for advances to contractors, and (2) the right of Banks to accept deposits with notice of such provisions and then to disregard the terms thereof.

STATEMENT OF THE CASE.

1. *Circumstances under which the contracts were made.* In 1917-18 a great war was waging. War materials in vast quantities were urgently needed in the quickest possible time. To manufacture them in quantities large enough to meet the inconceivably great demands of modern warfare, required the building of vast munition plants at tremendous cost and the purchase of huge supplies of raw materials. No private contractors would assume such financial burdens unassisted. The Government had to finance them; and yet it could not do so, because, payments *in advance* for supplies *to be* furnished to the United States were expressly forbidden by the Act of January 31, 1823 (3 Stat. 723); *The Floyd Acceptances, 7* Wall. 666, 682).

In order to overcome that obstacle, Congress authorized the War Department

> "*to advance payments* to contractors *for supplies* * * * in amounts not exceeding 30% of the contract price of such supplies" Act October 6, 1917; 40 Stat. 383)."

Under the authority of that Act, the Government made enormous advance payments for supplies to contractors so as to furnish them with funds to erect plants in which to manufacture supplies; and in order to insure that the advances so made should be used only for the purpose of producing such supplies, it was customary to require the advance payments to be deposited in "special accounts" in bank, separate from the Contractor's other funds, and to be used only for

the specific purpose of furnishing supplies, including, where necessary, the enlargement or erection of plants for that purpose. Some instances of such advances are noted in the margin.*

2. *The "Principal Agreement" of May 9, 1918.* In the darkest hours of the Great War, a "Principal Agreement," dated May 9, 1918, was made between the United States and the Butterworth-Judson Co. (called the Contractor), which provided for the erection of a $7,000,000 picric acid plant and the manufacture thereat of 72,000,000 pounds of picric acid on the following terms (R. 38-60);

PRINCIPAL AGREEMENT DATED MAY 9, 1918.

I. The UNITED STATES agreed:

(1) To pay the entire cost of acquiring a site and erecting thereon a completely equipped picric acid plant; including the *pro rata* share of the Contractor's overhead expenses (Art. II-VI, R. 40-43);

(2) To pay 53 cts. a pound ($38,160,000) for 72,000,000 pounds of picric acid as it was delivered (R. 43, 46); with detailed provisions for (*a*) the possible furnishing by the United States of certain raw materials (to remain U. S. property), in which event there should be a corresponding abatement of the contract price, (*b*) the United States paying to the Contractor 80% of the actual cost of any raw materials bought by the Contractor (to be credited on the contract price); and (*c*) a *pro tanto* increase or decrease of

* Maxwell Motors Corporation, $5,000,000; Recording and Computing Machine Co., $2,000,000; West Penn Power Co., $2,000,000; Winslow Bros. Co., $400,000; Frost Manufacturing Co., $100,000; Minnesota Steel & Machine Co., $1,000,000; Huddleston-Marsh Co., $170,000; American Clay & Machinery Co., $2,900,000; Willys Overland Co., $2,675,000.

the 53 ct. price, as the cost of raw materials should vary from a scale fixed in the contract (R. 43-48).

(3) To recommend to the War Credits Board that it approve an *advance payment* of $1,500,000 to the Contractor "upon such *terms and conditions* and *secured* in such manner as said Board shall prescribe" (R. 50); and if the Contractor was required by the War Credits Board to pay any interest on such advance, the United States would *reimburse* the Contractor therefor as a part of the cost to be paid by the United States under the contract (R. 50); and if the $1,500,000 advance was not approved by the War Credits Board in 10 days, the Contractor might cancel the contract (R. 50).

II. The BUTTERWORTH-JUDSON Co. agreed:

(1) To design, construct and equip the plant for a profit of $1 and no more (R. 43).

(2) To manufacture and deliver 72,000,000 pounds of picric acid, to be made under the phenol process or such other process as the United States should require (R. 43, 55).*

(3) To furnish a $500,000 surety bond for the faithful performance of the contract (R. 58-59)—the premium (like the interest on the advance) to be a part of the cost *to be borne by the United States.*

III. BOTH PARTIES agreed:

(1) That the title to *"all parts* of the plant" and to *"all materials* used in the construction, maintenance or operation thereof" should vest in the United States simultaneously with *any* payment on account thereof by the United States (R. 53).

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* If any process other than the phenol process should be required, the United States was to bear all expenses of such manufacture and pay to the Contractor a fixed profit of 4 cts. per pound (R. 49).

(2) That the United States might *cancel* the contract at any time that its need for the plant or its output ceased to exist (R. 55); in which event the United States should (*a*) reimburse the Contractor for all costs and expenses, not previously reimbursed, and assume all the Contractor's outstanding obligations incurred under the contract (R. 55-56); and (*b*) pay for all picric acid wholly or partly manufactured; but if the contract should be cancelled before 18,000,000 pounds were delivered, then the United States was to pay the contractor 3 cts a pound for the undelivered portion up to 18,000,000 pounds (R. 56).

3. *The "Supplemental Agreement" of May 22, 1918.* A few days later (the approval of the War Credits Board having been apparently secured), a "Supplemental Agreement" dated May 22, 1918, was made covering the terms, conditions and security of the $1,500,000 advance payment, which was recited to be made "under the Principal Agreement" "in the interest of both parties hereto and in order to expedite the delivery of the said supplies" as follows (R. 61-66):

SUPPLEMENTAL AGREEMENT DATED MAY 22, 1918.

I. The UNITED STATES (called the Government) agreed:

(1) To advance to the Contractor $1,500,000 "on the terms and security" therein mentioned (R. 62);

(2) Not to negotiate nor demand payment of the Contractor's $1,500,000 note given as security for such advance, so long as the contractor was not in default; and to return to the Contractor the note and surety bond upon the Contractor's complete performance of its obligations under the Supplemental Agreement (R. 64-65).

(3) To permit the Contractor to repay to the Government, in cash, at any time, the entire unpaid balance of the advance and interest.

II. The BUTTERWORTH-JUDSON Co. (called the Contractor) agreed:

(1) "As *collateral security* for the recoupment or return of the above mentioned advance [$1,500,000] and any interest due", the Butterworth-Judson Co. would (*a*) execute its demand note for $1,500,000 bearing 6% interest, payable to the Secretary of War (R. 64); and (*b*) furnish a $750,000 surety bond for the faithful performance of its obligations under such Supplemental Agreement (R. 64), *i. e.* the return of the $1,500,000 in cash or its discharge by furnishing to the Government picric acid at the rate specified in the Supplemental Agreement (R. 62).*

(2) To account to the Government for the $1,500,000 advance, with interest thereon, (at the rate of 7% for the 9 days in May, and thereafter at such rate as the War Credits Board should determine from month to month), by applying the advance, with interest, to the payment of vouchers presented by the Contractor to the Government covering deliveries of picric acid under the Principal Agreement, as follows (R. 62):

(*a*) In paying the first vouchers due to the Contractor for picric acid deliveries, until the Government shall have recouped (of the advance) $500,000, *i. e.* about 943,396 pounds or (say) the first 5 days run of the plant;

* In the event of the Contractor's default with respect to the payment of the $1,500,000, the Government was given the power to sell, at public or private sale, the Contractor's $1,500,000 note and to apply the proceeds to the payment of the advance and the Government might become the purchaser of the note freed from *every trust* and obligation (R. 64).

(*b*) Then the Government should pay for the picric acid received until 57,000,000 pounds shall have been delivered (about the next 9 months' run of the plant).

Thereafter, the remaining $1,000,000 of the advance (with accrued interest) should be discharged by applying it at the rate of 10 cents for each pound of picric acid delivered; *i. e.* until about 11,000,000 pounds were delivered—or the next 2 months' run.*

(3) If the Government should fail to recoup its $1,500,000 in the above manner (even though it was because the Government cancelled the contract), then the Contractor should return to the Government any balance of the $1,500,000 (and interest) remaining unpaid, after deducting (1) the recoupments made, and (2) "all liquidated accounts that may be due and owing under the Principal Agreement from the Government to the Contractor, *i. e.*, any unpaid costs, expenses, disbursements, interest on the advance, and the 3 cents per pound liquidated damages on undelivered picric acid up to 18,000,000 lbs. (R. 63, Cf. R. 56).

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* The schedule for the liquidation of the $1,500,000 and interest would work out about as follows, based on the contract estimate of the time of completion and capacity.

Time Consumed	Picric Acid Deliveries	Price to be Credited	Amount Liquidated
5 days	943,396 lbs.	.53	$500,000
280 "	56,056,604 "	no liquidation	
50 "	10,000,000 "	.10	1,000,000
5 "	1,000,000 "	(est) .10	100,000 (Int.)
340 "	68,000,000 "		$1,600,000

In this way it was contemplated that the entire $1,500,000 advance would be repaid before the 72,000,000 lbs. contract was completed.

The interest (estimated at $100,000), while required by the War Credits Board to be paid by the Contractor by deliveries of picric acid, was in turn, however, to be *reimbursed* to it by the United States as a part of costs (Principal Agreement, Art. XVII; R. 50).

(4) To deposit the $1,500,000 in a "Special Account," to be disbursed *only* for certain specific purposes. As the controversy turns on this clause, it will be given in full (R. 64-65).

"Article VI

"The Contractor *shall deposit* the money advanced hereunder *in special accounts* in banks, *separate from its other funds,* and shall draw on said accounts *only* in payment of expenditures made and obligations incurred in designing, constructing and equipping the plant specified in the Principal Agreement, and for other equipment and material, labor and overhead expense, required in the *direct performance* of the Principal Agreement, unless otherwise authorized in writing by the War Credits Board.

The contracting officer may require that the contractor shall deposit in said accounts funds paid by the Government to the contractor reimbursing the contractor for expenditures made from this advance in designing, constructing and equipping the plant, as provided in Article VI of said contract between the parties hereto, dated May 9, 1918.

The contractor *shall secure* from the banks with which such accounts are placed, *such interest* as is *usually allowed* for similar accounts and shall *credit or pay said interest to the Government* in such manner as the contracting officer may direct."

4. *The Surety Company bonds.* On the same day, May 22, 1918, the Butterworth-Judson Co. furnished (but at the *Government's cost* as allowed by the contract, R. 59) two separate surety company bonds, as follows:

(*a*) One for $500,000 conditioned for the faithful performance of the Principal Agree-

ment of May 9, 1918 only, *i. e.*, erection of the plant and the manufacture of picric acid thereat (R. 67-69).

(*b*) One for $750,000 conditioned for the performance of the Supplemental Agreement of May 22, 1918, *i. e.*, the proper application of the $1,500,000 advance and its repayment or the return of the unexpended balance [$1,059,613.99] in the event of the cancellation of the contract before such repayment could be effected by deliveries of acid (R. 73-75). Under this bond, the Surety Companies are liable to the United States, if the Banks succeed in holding the $519,613.99 which the Butterworth-Judson Co. is under bond to return to the United States.

5. *The $1,500,000 advance.* The Government advanced the $1,500,000 to the Butterworth-Judson Co. which simultaneously executed its demand note therefor at 6% interest payable to the Secretary of War, which is still held by the Government and no demand for its payment has been made (R. 25, 26).

The Butterworth-Judson Co. promptly deposited the $1,500,000 advance in the several Banks, appellees herein, in "Special Accounts" separate from its other funds (R. 26).

The Banks knew that the deposits were made with the $1,500,000 furnished by the Government for the specific purpose of being used solely in the building of the plant and the manufacture of picric acid thereat; and with such knowledge *accepted* the deposits in "Special Accounts" (R. 30).

6. *The construction of the plant.* The Butterworth-Judson Co. began the erection of the plant and continued work at a cost to the Government of over $7,249,035.16 with the plant only 50%

completed, when on December 7, 1918. the Armistice having been signed, the Government cancelled the Principal Agreement under the reserved power to terminate it, if the need for the plant and picric acid ceased to exist (R. 27).

CLAIMS OF THE BANKS.

7. *Chase National Bank.* On May 27, 1918, the Butterworth-Judson Co. deposited its entire $1,500,000 advance in the Chase National Bank in a "Special Account", which as the result of checks drawn thereon and Governmental reimbursements thereto, was, after nearly four years, to wit, on April 21, 1922. $232,844.80 (R. 31, 133).

With full knowledge of the nature of that "Special Account", of the restrictive terms of its deposit, and of the Government's rights therein as set out in Art. VI of the Supplemental Agreement (R. 64), the Chase National Bank, long *after* the cancellation of the contract, loaned $600,000 to the Butterworth-Judson Co. as follows (R. 30, 133, 134):

1920	
August 30.....	$250,000
Sept. 7.....	350,000
Total loans.....	$600,000

Nearly two years thereafter, to-wit, on April 21, 1922, *after* the Butterworth-Judson Co. was in financial difficulties. and *on the same day* that it consented to the appointment of a Receiver (R. 10), the Chase National Bank appropriated to itself the $232,844.80 standing to the credit of "Butterworth-Judson Co. *Special Account*" and applied it towards the payment of its own $600,000

claim against that company, so as to reduce it from $600,000 to $367,155.20 (R. 31, 134).

8. *American Exchange National Bank.* In June, 1918, the Butterworth-Judson Co. opened a similar "Special Account" with the American Exchange Bank, the balance in which on April 21, 1922, was $115,501.60 (R. 31, 172).

With similar full knowledge as to the facts, the American Exchange Bank long *after* the cancellation of the contract, loaned $300,000 to the Butterworth-Judson Co. as follows (R. 30, 171):

1921	
January 10	$100,000
March 28	200,000
Total loans	$300,000

Likewise, on the same day (April 21, 1922) that the Butterworth-Judson Co. consented to a Receivership, the American Exchange Bank appropriated the $115,501.60 deposit in the "Special Account" toward the payment of its own $300,000 claim (R. 31, 172).

9. *New York Trust Co.* The "Special Account" was opened with the New York Trust Co. (or rather with a bank subsequently consolidated with it) on June 19, 1918, and the balance therein on April 21, 1922, was $70,225.87 (R. 31, 153).

With full knowledge of the facts, the New York Trust Co., long after the contract cancellation, loaned $100,000 to the Butterworth-Judson Co. (R. 153). On the same day as the other Banks acted (April 21, 1922), the New York Trust Co. appropriated the $70,225.87 balance towards the payment of its $100,000 note (R. 31, 153).

10. *National Newark & Essex Banking Co.* On June 4, 1918, the Butterworth-Judson Co. deposited $250,000 of the Government advance in a "Special Account" (R. 31, 195, 197); and on the same day the Newark & Essex Bank loaned it $250,000, with full knowledge of the restrictive character of the "Special Account" deposit (R. 30, 195, 198, 208).

Simultaneously with the other Banks, on April 21, 1922, the Newark & Essex Bank appropriated the then $101,166.10 balance in the "Special Account" toward the payment of its $250,000 debt (R. 31, 198).

11. *The actions of the parties under the contracts.* During the construction period, the Butterworth-Judson Co., in strict accordance with the terms of the Supplemental Agreement (Art. VI, R. 64-65), from time to time, drew checks on the various $1,500,000 "Special Accounts" in payment of the expense of erecting and maintaining the plant (Art. VI, IX, R. 42, 45); and the Government reimbursed it therefor, which reimbursed sums were in turn re-deposited in the "Special Accounts" as required by Art. VI (R. 65) so as to keep the $1,500,000 advance in the "Special Accounts" as nearly intact as possible (R. 26). The reimbursements aggregated about $8,500,000 for the plant (R. 27). After the Government cancelled the contract, it assumed and paid all the outstanding obligations incurred by the Butterworth-Judson Co. in connection with the plant (R. 27, 28).

The Butterworth-Judson Co. refunded $348,550 to the Government, which then left the account (excluding interest which the Butterworth-

Judson Co. were exonerated from paying, Art. XVII, R. 50) as follows (R. 33):

Advance Payment	$1,500,000
Refunded to U. S. by Contractor (R. 28)	348,550
	$1,151,450
Retained by the Contractor as alleged "liquidated damages" on Cancellation of contract; 18,000,000 lbs. at 3¢ a pound (Art. XXVI, R. 56)..	540,000
Balance concededly due to U. S.....	$611,450

It will be especially noted (1) that all the Banks *accepted* the deposits with *full knowledge* of the contractual restrictive limitations on the "Special Accounts", the interest of the Government therein and the specific purposes for which the special deposits were made and intended to be used; (2) that all the Banks (except the Newark & Essex Bank) made their loans to the Butterworth-Judson Co. long *after* the Government's cancellation of the contract, and when the "Special Accounts" had become static as it were, with the rights of the Government and the Contractor therein fixed; and (3) that, *by concert of action between the Banks,* they, on the *very day* that the Butterworth-Judson Co. verified its answer *consenting to a Receivership,* seized the "Special Account" deposits and applied them in payment of their own respective claims against the company.

Does the Banker's right of "set-off" authorize such conduct? That is the question here involved.

12. *History of the Litigation.* On January 9, 1923, the United States filed its bill against the Butterworth-Judson Co., its Receivers, the Banks, and the Surety Companies on the $750,000 bond,

alleging the above facts, and asking (*a*) an accounting with the Butterworth-Judson Co. (*b*) a recovery from the Banks of the "Special Accounts" so seized, and (*c*) a judgment over against the Surety Companies upon their bonds for any balance finally found due by the Butterworth-Judson Co. to the Government (R. 3-36).

The Government's total claim against the Butterworth-Judson Co. on account of the advance payment is (*after* crediting the $348,550 refunded) about ~~$800,000~~ $1,150,000

The Receivers and Surety Companies answered and also filed Counter-claims against the Banks, seeking to have the "Special Account" deposits paid over to the United States (R. 101, 128).

The Banks answered to the merits, and also moved to dismiss the bill and the Counter-claims for want of equity (R. 241-262).

The District Court (A. N. Hand, J.) dismissed both the bill and the Counterclaims upon the sole ground that, as the Butterworth-Judson Co. was *nominally* to pay interest to the Government on the $1,500,000 advance (even though such interest was to be reimbursed to it by the Government), this made the relation between the company and the Government merely that of an ordinary debtor and creditor, and that the Banks were entitled to "set-off" the "Special Accounts" deposits against what the company owed them, saying (R. 265):

> "There is no doubt that special deposits *might* have been made sufficient to prevent a set-off by any banks having notice of the nature of the deposits, but under the agreement involved in this case the advances were *not*, in my opinion, special deposits of that limited character, and *the relation was one of*

debtor and creditor. The provision for interest, even though the amount of interest was allowed to the contractor in the final adjustments as part of the cost or expense incurred, *made the relation,* in my opinion, one of *debtor and creditor.*

The agreement to account for the fund and to expend it in a certain way was no more than a *contractual provision* between the parties requiring the contractor to promise to use the advance only for Government work, and did not create either a trust or a special deposit with the fiduciary relation between the parties which prevented a set-off by the banks. I have been referred to no case exactly like the present one and shall, therefore, not cite authorities, but I think the ordinary rule that the *charge of interest* upon a transfer of money makes the relation one of debtor and creditor, *determines the question.*"

OPINION OF THE CIRCUIT COURT OF APPEALS.

The Circuit Court of Appeals affirmed the decree (R. 312; *U. S.* v. *Butterworth-Judson Corp.,* 297 Fed. 971).

The Court of Appeals held, for various reasons assigned, that the relationship between the Butterworth-Judson Co. and the United States was simply one of debtor and creditor (R. 317); that the $1,500,000 was in no sense a trust fund capable of being followed into the hands of the Banks, *because* there was no designated beneficiary nor any designated trustee who was not a beneficiary (R. 217); that it was not a "revolving fund" of the United States but a loan (R. 317, 318); that it was not a "Special Deposit" in the sense that

the Banks must return the specific thing left with them (R. 319); that the case was controlled by their own decision *In Re Interborough Consolidated Corp.,* 288 Fed. 334 (R. 319); and said (R. 319):

> "We see no justification for applying to the funds on deposit any doctrine of trusts or equitable lien or equitable assignment."

The Court of Appeals gave no consideration whatever to the point that when a bank *accepts* a deposit with notice from the depositor that the money is deposited for the express purpose of being used for certain specific purposes, the bank thereby accepts the deposit *subject to such terms,* which are manifestly inconsistent with the theory of a general deposit against which the bank might lend money, and that the bank cannot thereafter assert its right of set-off against such a deposit.

ASSIGNMENT OF ERRORS.

The assignment of errors raises the question of the sufficiency of the bill (R. 272).

SUMMARY OF POINTS DISCUSSED.

1. The $1,500,000 advance payment to Butterworth-Judson Co. was subject to an equitable lien in favor of the United States and it was impressed with the character of a trust fund (pp. 19-39, *infra*).

2. The Banks accepted the deposit with full knowledge that the Butterworth-Judson Co. made the deposit for the sole purpose of having the money applied by its own checks to certain specific purposes.

Therefore, the Banks cannot assert the right of set-off against the deposit (pp. 40-67, *infra*).

3. Analysis of the opinion of the Circuit Court of Appeals and a response to certain contentions of the Banks (pp. 68-78, *infra*).

FIRST POINT.

The $1,500,000 advance payment to Butterworth-Judson Co. was subject to an equitable lien in favor of the United States and it was impressed with the character of a trust fund.

The effect of the two contracts is briefly summarized in the margin*.

Under the enormous pressure for American aid to the Allies, during the great German drive of the Spring of 1918, when the fate of the war was

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* 1. The Government agreed to *pay* for a site to be selected by the Contractor, together with *all expenses* incident to its acquisition (R. 40).

2. The Contractor agreed to build thereon, *at the Government's expense,* a complete plant, *without any profit* or even compensation for its own services (R. 43).

3. The Contractor agreed to manufacture and deliver 72,000,000 pounds of picric acid at 53 cents per pound.

4. The Contractor had to make "all necessary expenditures in respect of the costs and expenses" incurred in building the plant, and to submit "satisfactory evidence" of the expenditure; and, thereupon, the Government "shall promptly *reimburse* the Contractor therefor" (Art. VI, R. 43).

Furthermore, in the manufacture of the picric acid itself, the Contractor had to pay for its material, etc., before it could get the 80% reimbursement (R. 44).

5. Therefore, in order to finance the Contractor's needs, the Government agreed to advance to it $1,500,000 upon these conditions:

(*a*) The contractor to give its demand note for $1,500,000 with interest; and to give a $750,000 surety bond for the proper application of the money.

(*b*) The Contractor, nominally, to pay interest on that $1,500,000, but the Government to reimburse any sums paid as interest, by including such sums as cost to be repaid to the Contractor.

(*c*) The Contractor to deposit the $1,500,000 in Banks, in "Special Accounts", separate from its

trembling in the balance, the United States sought by these and many similar contracts, to secure the building of munition plants and the production of munitions thereat, in vast quantities, in the quickest possible time. It was willing to furnish the necessary capital for the construction of the plants and to assist the contractor in financing the operation thereof; but it intended to insure that the Government monies thus advanced should be devoted to those purposes alone and not be diverted to other aims of the Contractor, nor be subject to seizure by the Contractor's general creditors.

By the contracts in this case, the Government made an advance payment of $1,500,000 to the Contractor, who agreed to deposit it in "special accounts" in banks, separate from its other funds,

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other funds and to draw on the $1,500,000 only (1) to pay for the erection of the plant, and (2) to pay for labor, material and equipment used in manufacturing the picric acid.

(*d*) The Contractor to redeposit in such "Special Accounts" all sums it received from the Government in reimbursement of the Contractor's outlays in building the plant.

(*e*) *The Contractor to pay to the Government all interest* allowed by the Banks on the "Special Accounts".

(*f*) The Contractor to account for the $1,500,000 to the Government (by furnishing picric acid) as follows: (1) $500,000 by *furnishing free* the first 943,396 lbs. manufactured, (2) no further payments until after 57,000,000 lbs. were delivered, and (3) then the $1,000,000 balance, with interest, to be paid by a credit of 10 cents a pound on about the next 11,000,000 lbs. of future deliveries of picric acid.

6. If the Government did not get its $1,500,000 recouped in the manner above outlined, the Contractor was to return to the Government any *unexpended* balance in the "Special Accounts" after deducting any sums the Government owed the Contractor for advances, interest, or liquidated damages if the contract was cancelled.

to pay to the Government all interest allowed by the banks on such deposits, and to draw upon such accounts only in payment of expenditures required in the direct performance of the contract, to-wit: the erection of the plant and the production of munitions thereat* (R. 64, 65).

The Butterworth-Judson Co. scrupulously fulfilled all the contract requirements.

We submit:

I. The contracts created in favor of the United States an equitable lien upon the fund, or impressed it with the character of a trust fund.

The legal effect of the contracts cannot be determined by any one provision, but the totality of them must be regarded, and their relations and purposes (*Duesenberg Motors Corp.* v. *U. S.*, 260 U. S. 115, 122).

The contracts should be construed as adopting whatever method or form, consistent with the facts and with the rights reserved, is most fitted to reach the result seemingly desired (*Sexton* v. *Kessler,* 225 U. S. 90, 96; *Barnes* v. *Alexander,* 232 U. S. 117, 120).

1. While the title to the $1,500,000 fund, and the replenishments thereof, passed to the Butterworth-Judson Co., the United States and Butterworth-Judson Co. intended, and by contract attempted, to insure (1) that the fund should be set apart in a "Special Account", separate from all other moneys, and devoted solely to the erection of the plant and the manufacture of munitions

* The Government took a $750,000 Surety Company bond as additional security that the $1,500,000 would be used only as stipulated in the contract (R. 64).

thereat, and (2) that to the extent *not* so devoted, it should be *returned* to the United States.

The United States did not part with,—nor did the Butterworth-Judson Co. acquire,—complete and absolute control over the fund, as the following facts, inconsistent with unrestrained ownership, demonstrate:

(*a*) The money had to be kept in "*special accounts* in banks, separate from its other funds" (R. 64).

(*b*) It could *not* be used for the company's *general* purposes; but it could be drawn from bank *only* to pay for erecting the plant or making Government munitions thereat (R. 65).

(*c*) The Butterworth-Judson Co. was bound to pay to the United States *all interest* which the Banks allowed on the deposit (R. 65).

(*d*) The Butterworth-Judson Co. reserved the right at any time to "repay" to the Government, in cash, the entire balance of the fund (R. 63). This shows it was not a *payment* in the ordinary sense.

(*e*) The Butterworth-Judson Co. was compelled to *return* any balance to the Government, if the supplies were not furnished.

(*f*) The Butterworth-Judson Co. gave a note as evidence of the advance, and also furnished a $750,000 surety bond, as security for the faithful performance of its obligations (*a*), (*b*), (*c*) and (*e*), *supra*.

(*g*) If the Butterworth-Judson Co. failed to keep the money in a "special account" separate from its other funds, or if it used it for any other purpose than for the plant and munitions, the Government could sell the note and buy it in "free of all *trusts* and claims

whatsoever" (R. 64) which indicates the qualified nature of the advance payment.

(*h*) Under the authority given by the Act of October 6, 1917 (40 Stat. 383), for the Secretary of War to "prescribe [and to] require adequate security for the protection of the Government for the [advance] payments", he created a War Credits Board to administer such "advance payments" and prescribed the "rules and restrictions" under which they could be made.

One of the directions to the Government's contracting officers was that, in order that "the Government shall be adequately protected", the advance payments should be made (R. 320-322)

> "under such conditions and restrictions that the funds advanced are definitely procured to be held *in trust* until paid out under the contract, for property to which the Government holds or *automatically acquires title*, or in meeting expenses *incurred in the direct performance* of the contract for supplies."

The contracts here, by appropriate terms, limited the advance payments in precisely that very manner and almost in that verbatim language.*

Both parties intended to safeguard, and thought they had safeguarded absolutely, the application of the $1,500,000 solely to work *under* the contract.

Will this Court say that the contract legally *failed* to accomplish that end?

2. The lower Courts both held that it was a loan, pure and simple; that the *only* relation was that

*Cf. Art. XXII (R. 53) vesting title automatically *in* the U. S. to "all *parts*" of plant, and "*all materials*" on *any* payment therefor; Art. VI (R. 64, 65), creating a separate fund to be used only for building the plant or in direct performance of the contract for supplies.

of debtor [Butterworth-Judson Co.] and creditor [United States]; and that no fiduciary or equitable element was involved (R. 265, 317, 319). That was clearly erroneous.

Certainly such was not the intention of the parties, for if it had been, then why all the special provisions, limiting the Contractor's power over his own money? If it be responded that such provisions were to secure the ultimate return of the fund itself to the United States, then that, by very definition, constituted an equitable lien upon, or equitable assignment back of, the fund to the Government.

A few illustrations will be useful.

(A) Suppose a tenant leased a building from a landlord for 3 years at $10,000 a year rent; and the lease required the tenant to pay the 3 years rent [$30,000] in advance, and the landlord to deposit such advance payment of rent in a "special account" in bank, which was to be applied solely and exclusively to the fitting up of the leased premises for the specific needs of the tenant. Is it possible that under such circumstances, the bank with knowledge of those facts could accept the deposit and *immediately* upon deposit of the $30,000 in the "special account", seize it and offset it against a prior debt it had against the landlord?

Or, again, is it possible that, shortly after the deposit was made, the landlord's creditors could attach the $30,000 "special account" as a general asset of the landlord? Or, if the landlord became bankrupt, could the trustee in bankruptcy seize the deposit for distribution among the creditors generally without any regard to the prior lien or claim thereon of the tenant who had made the advance payment under such restrictive conditions?

(B) Suppose that during the war emergency, under the authority of the Federal Control and Transportation Acts of March 21, 1918, February 28 and June 5, 1920 (40 Stat. 451, 468, 946), the Government had advanced to a railroad $2,000,000 with which to buy "equipment" or make "additions and betterments" or build a side track to a powder plant, in order "properly to meet the transportation needs of the public" or because "desirable for war purposes". And suppose, as "security to be given for repayment" the Government had stipulated that the advance should be deposited in a "special account" in bank, to be checked out only for those purposes. Can it be that a great Governmental plan in aid of objects entrusted to it by the Constitution, could be frustrated by some general creditor, or past-due coupon holder, or stockholder whose declared dividend had not been paid, attaching such fund, leaving the Government remediless and the railroad without the facilities desired?

A bank's right of set-off is even weaker than the right of an attaching bondholder (who has a mortgage on the Company's property, franchise, rents and profits); and yet would anyone contend that the bond-holders and creditors, knowing the arrangement by which the money was advanced by the Government, could seize it to pay their own claims?

Or could the bank, *eo instanti* the deposit was received with full knowledge of such terms, appropriate the $2,000,000 as a set-off against a floating debt it held against the railroad?

(C) If the Banks have, as the lower Courts held, the unrestrained right of "set-off", they

growing out of the law merchant and is one that gives the Bank, in effect, a preference over other creditors. It must be clearly shown before it can be maintained. If the right of "set-off" is denied to the Banks, they are not really losing anything, but are being merely put on a parity with other creditors.

4. Parties may, by contract, create an *equitable lien* on property sufficiently identified. An equitable lien is merely a right to secure the performance of some outstanding obligation, by means of a proceeding directed against *the thing* which is the subject of the lien. It is not, strictly speaking, a trust, and the Butterworth-Judson Co. as the owner of the fund, was not, strictly speaking, a trustee for the United States—although many writers would so treat it (3 Pomeroy's Equity Jurisprudence (4th Ed.) § 1234).

For example, some writers would say that when the deposit was made in the Banks, the Butterworth-Judson Co. had a *chose in action* against the Banks for the amount of the deposit, which could be discharged by the Banks paying the deposit to Butterworth-Judson Co. or to the holders of checks duly drawn thereon; that the Butterworth-Judson Co. was, as between itself and the Government, a *Trustee* of such *chose in action,* for the United States as the beneficiary thereof; and that the Banks, having knowledge of such trust relationship, cannot exercise the right of set-off (*Beaver Board Cos.* v. *Imbrie & Co.,* 287 F. R. 158, 162).

5. The Butterworth-Judson Co. was under obligation to expend this money in a specific manner,

and no other. To secure the performance of that obligation, the fund was sequestered from all its other funds. It was denied the interest earned thereon. It could only use it for certain limited purposes under that particular contract. The form, or particular nature of the agreement which shall create an equitable lien, is not very important, for equity looks at the *final intent and purpose* rather than at the form, which is immaterial if the intent appears to make any identified fund a security for the fulfillment of an obligation (3 Pom. Eq. Jurisprudence, 4th Ed. §§ 1235, 1237; *Hauselt* v. *Harrison,* 105 U. S. 401, 406-408; *Walker* v. *Brown,* 165 U. S. 654, 664-5; *Ingersoll* v. *Coram,* 211 U. S. 335, 368; *Barnes* v. *Alexander,* 232 U. S. 117, 121.)).

It must be remembered, as held in *Knatchbull* v. *Hallett,* 13 Ch. D. 696, and adopted in *National Bank* v. *Insurance Co.,* 104 U. S. 54, 68, that the Rules of Equity, are, from time to time, altered, improved, refined and invented for the purpose of better securing the administration of justice; that equity rules are progressive, and that one must look to the more modern rather than to the ancient cases—although the doctrine of equitable liens as applicable here is very ancient, as two old English cases, presently to be noticed, show.

The growth of the doctrine of this Court with respect to equitable liens is very marked by contrasting *Christmas* v. *Russell,* 14 Wall. 69 (1870), and *Trist* v. *Child,* 21 Wall. 441 (1874), with the progressive extension in the later cases of *Fourth Street Bank* v. *Yardley,* 165 U. S. 634; *Walker* v. *Brown, Id.* 654; *Ingersoll* v. *Coram,* 211 U. S. 335, 368; *Barnes* v. *Alexander,* 232 U. S. 117, 120

(practically overruling *Trist* v. *Child*), and *Valdes* v. *Larrinaga*, 233 U. S. 705.

In 3 Story's Equity Jurisprudence (14th Ed.) § 1637, it is said:

> "Indeed there is generally *no difficulty* in equity *in establishing a lien* not only on real estate but on personal property, or on money in the hands of a third person, wherever *that is a matter of agreement, at least against the party himself*, and third persons who are volunteers or have notice. For it is a general principle in equity that as against the party himself, and any claiming under him voluntarily or with notice, such an agreement raises a *trust*."

In 1 Pomeroy's Eq. Jurisprudence, 4th Ed. § 165, it is said:

> "An equitable lien is not an estate or property in the thing itself, nor a right to recover the thing,—that is, a right which may be the basis of a possessory action; it is neither a *jus ad rem* nor a *jus in re*. It is simply a right of a special nature *over* the thing, which constitutes a charge or encumbrance upon the thing, so that the very thing itself may be proceeded against in an equitable action, and either sold or sequestered under a judicial decree, and its proceeds in one case, or its rents and profits in the other, applied upon the demand of the party in whose favor the lien exists. It is the very essence of this conception, that while the lien continues, *the possession* of the thing *remains with the debtor* or person who holds the proprietary interest subject to the encumbrance."

So here. The Butterworth-Judson Co. held possession of the fund, to-wit: a chose in action against the Banks, but the lien in favor of the

United States continued, although the possession of the fund had been surrendered by the United States and the title thereto had passed to the Butterworth-Judson Co.

Again, § 166:

> "When equity has jurisdiction to enforce rights and obligations growing out of an executory contract, this equitable theory of remedies cannot be carried out, unless the notion is admitted that the *contract creates some right or interest in or over specific property, which the decree of the Court can lay hold of,* and by means of which the equitable relief can be made efficient. The doctrine of *equitable liens supplies this necessary element,* and it was introduced for the *sole purpose* of furnishing a ground for the *specific remedies* which equity confers, operating upon *particular identified property,* instead of the general pecuniary recoveries granted by courts of law. It follows, therefore, that in a large class of executory contracts, express or implied, which the law regards as creating no property right nor interest analogous to property, but only a mere *personal right and obligation,* equity recognizes, *in addition to the obligation,* a peculiar right *over* the thing with which the contract deals, which it calls a 'Lien', and which, though not property, is analogous to property, and by means of which the plaintiff is enabled to follow the identical thing, and to enforce the defendant's obligation by a remedy which operates directly upon that thing."

In *Legard* v. *Hodges,* 1 Ves. Jr., 478 (quoted with approval in *Ketchum* v. *St. Louis,* 101 U. S. 306, 316), in order to raise a certain sum, a life tenant agreed to pay over one-third of the net

profits of his estate to certain Trustees. Subsequently he *conveyed* his life estate to other Trustees having notice of his former agreement. The second Trustees claimed that there was no lien upon the land by the first agreement, but a mere *personal covenant*. The Lord Chancellor (THURLOW) held that the contract was not a mere personal covenant with a remedy at law, but that

> "* * * whatsoever is the agreement concerning any subject real or personal, though in form and construction purely personal and suable only at law, yet in this Court it binds the conscience * * *, this maxim which I take to be universal that *wherever persons agree concerning any particular subject,* that in a Court of Equity as against the party himself, and any claiming under him voluntarily or with notice, *raises a trust.* These persons have so claimed; and therefore this is a pure TRUST estate, and they must be declared trustees for one-third of the clear annual profits, and must account from the time of taking possession having all just allowances."

This case was affirmed on rehearing by Lord Chancellor LOUGHBOROUGH.

In *Dodsley* v. *Varley,* 12 Ad. & E. 632, a seller delivered possession of certain wool to the purchaser, who placed it in a warehouse belonging to a third party, where it was weighed and packed in the purchaser's sacks. The course of dealing was for the wool to remain in the warehouse until paid for. It was neither removed nor paid for. In a suit by the purchaser it was held that although there had been a delivery and acception of the goods, the plaintiff retained a *special interest* in

them (not properly a lien) in respect of the arrangement not to remove the wool until paid for.

Lord Chief Justice DENMAN, in sustaining a verdict for the plaintiff, held that everything was complete except the payment of the price, and said:

> "We think that, upon this evidence, the place to which the wools were removed must be considered as the defendant's warehouse, and that he was in actual possession of it there as soon as it was weighed and packed; that it was thenceforward at his risk, and, if burnt, must have been paid for by him. Consistently with this, however, the plaintiff had, not what is commonly called a lien, *determinable on the loss of possession,* but a *special interest,* sometimes, but *improperly,* called a lien, growing out of his original ownership, independent of the actual possession, and *consistent with the property being in the defendant.* This he retained in respect of the term agreed on, that the goods should not be removed to their ultimate place of destination before payment. But this lien is consistent, as we have stated, with the *possession* having passed to the buyer, so that there may have been a delivery to, and actual receipt by, him."

These two English cases establish the proposition that by contract between two persons, one can retain a *specific interest* in, or lien upon, the subject matter of the contract, even though title and possession have both been parted with, as against third persons having notice of the arrangement.

This Court has held exactly the same thing.

In *Ingersoll* v. *Coram,* 211 U. S. 335, Ingersoll wrote Coram and Root inquiring what his fee would be and how it would be secured. They wrote him that he would get a $100,000 fee in

case their clients got their share of the estate, but that there would be no personal obligation against Coram except to pay the fee out of the funds secured from the estate by certain heirs. The Court held that Ingersoll thereby acquired a lien upon the shares of such heirs, saying:

> "It is evident, therefore, that Ingersoll asked for security in a definite and written form. We do not think it can be said that he sought *only* a promise to pay. That followed from his employment, and besides Coram stipulated against personal liability, but did obligate himself to pay 'out of the funds secured from the estate'. And this is the test of the agreement. It is the exception that establishes that as to Root there was a personal *and property* obligation; as to Coram, a *property* obligation."

In *Barnes* v. *Alexander,* 232 U. S. 117, Barnes had a contingent fee of 25%. He stated to a fellow lawyer, Alexander:

> "If you will attend to this case I will give you one-third of the fee which I have coming to me on the contingent fee from Shattuck, Hanninger and Marks."

This was a *personal promise* and Barnes contended that it gave to Alexander no specific lien against the fund itself. This Court held that Alexander had an equitable lien, saying:

> "He [Barnes] promised only that if, when and as soon as, he should receive an identified fund, one-third of it should go to the appellees. But he promised that. At the latest, the moment the fund was received the contract attached to it as if made at that moment. * * *

> The obligation of Barnes was as definitely limited to payment out of the fund as if the limitation had been stated in words, and therefore creates a lien upon the principle not only of *Wylie* v. *Coxe, supra,* but of *Ingersoll* v. *Coram,* 211 U. S. 335, 365-368, which cites it and later cases. See further to the same point, *Burn* v. *Carvalho,* 4 My. & Cr. 690, 702, 703; *Rodick* v. *Gandell,* 1 DeG., M. & G. 763, 777, 778; *Harwood* v. *LaGrange,* 137 N. Y. 538, 540. It is suggested that there is an American doctrine opposed to that which is established in England. We know of no such opposition. There is or ought to be but one rule, that suggested by plain good sense. * * * The latter firm filed no claim against the estate of Barnes, thinking that it owed them nothing but that they had one-third of the contingent fee. It is not necessary to consider whether the lien attached to what we have called the *res,* before the fund was received, as a covenant to set apart rents and profits creates a lien upon the land. *Legard* v. *Hodges,* 1 Ves., Jr. 477. It is enough that it attached not later than that moment."

In the case at bar, the Butterworth-Judson Co. promised that if, when, and as soon as, it received the identified fund of $1,500,000, it would be set aside in a special account and be applied only for specified benefits to the United States. At the moment the fund was received the contract attached to it as if it were made at that moment. The promise of the Butterworth-Judson Co. created a lien upon the fund on the authority of the above quotation.

In *Hauselt* v. *Harrison,* 105 U. S. 401, Hauselt advanced money for the purchase of skins which

one Bayer agreed to tan and deliver to Hauselt, who was to sell them and return the proceeds, less commissions and advance to Bayer. It was agreed that the skins should be considered as security for the moneys advanced by Hauselt. Bayer became financially embarrassed and it was agreed that Hauselt should take possession of Bayer's tannery and finish the tanning of the incompleted skins. It was held that Hauselt had an *equitable lien* on the skins, although Bayer had bought and paid for the skins and had them in his own tannery. It was conceded that the title to the skins was in Bayer. This Court held that Hauselt had something more than Bayer's mere promise; and that Hauselt had an equitable lien on the skins, saying:

> "Nor can it be reasonably doubted that this equitable lien was capable of enforcement. If Bayer had, *in disregard and violation of his agreement, undertaken to divert the skins, whether in a finished or unfinished state, to some other and unauthorized use,* it would have been in fraud of the rights of Hauselt, *and a court of equity would not have hesitated by an injuncion to prevent the commission or continuance of the wrong.* Bayer would, under such circumstances, be treated by a court of equity *as a trustee,* fraudulently dealing with and misappropriating trust property, and Hauselt would be protected in his rights, as owner of a beneficial interest in the property, entitled to the enjoyment of the specific fruits of the agreement. * * *
>
> It is quite true that Hauselt could not have compelled Bayer, by an action at law, to deliver to him possession of his tannery and its contents; nor could he have recovered possession of the skins, tanned or untanned, by

force of a legal title; but it is equally true that, in equity, he could, by injunction, *have prevented Bayer from making any disposition of the property, inconsistent with his obligations under the contract;* and upon proof of his inability or unwillingness to complete the performance of his agreement the court would not have hesitated, in the exercise of a familiar jurisdiction, to protect the interests of Hauselt, by placing the property in the custody of a receiver for preservation, with authority, if such a course seemed expedient, in its discretion, to finish the unfinished work, and ultimately, by a sale and distribution of its proceeds, to adjust the rights of the parties."

This case is direct authority for the proposition that, if the Butterworth-Judson Co. had sought to use the advance payment for foreign purposes, the Government had such an equitable interest in the fund as to sustain an injunction to prevent its diversion; and it was not remitted to an ordinary action at law for damages.

That point being conceded, it establishes an *equitable lien* in favor of the United States, which is fatal to the alleged right of set-off in the Banks.

By the contract in the case at bar, there was an absolute and exclusive appropriation by the Butterworth-Judson Co. of the funds deposited in the special account for the single purpose of paying for the plant and the munitions, in default of which it was to be returned to the United States. It was a much more definite appropriation than that sustained in *Curtis* v. *Walpole Tire Co.*, 218 Fed. 145, 148 (C. C. A., 1st Cir.).

It was entirely competent for the United States and Butterworth-Judson Co. to contract with ref-

erence to a specific fund; and for the Government to surrender the possession of and the title to such fund, and yet to require as a condition of parting with the money, that the fund should be kept in a special account, separate from all other funds, and devoted to a specific object only. This gave to the United States a right to have the thing itself, *i. e., the fund,* devoted to the purposes specified. This right over the fund is generally called an *equitable lien.* It is a right capable of enforcement in equity and is good not only as against the Butterworth-Judson Co., but against all persons taking the fund with notice of such reserved right. An equitable lien is "intensely undefined" (*Brunsdon* v. *Allard,* 2 El. & El. 19) and is "liberally extended in modern times to facilitate mercantile transactions" (288 Fed. 349).

If the foregoing proposition be conceded, then it follows as a corollary that the Bank, having knowledge of this equitable lien, could not assert the right of "set-off" against it.

II. *The Banks having notice of the Government's lien, could not "set-off" the deposit against an indebtedness due them.*

The Banks knew all the facts concerning the deposits in the special accounts, the contracts under which they were made, and that the Butterworth-Judson Co. was required to ear-mark and keep the special accounts separate from all its other funds for the purpose of facilitating the construction of the plant and carrying out the obligations imposed by its contract with the Government (R. 29, 30).

It is elementary that when a Bank has notice of the trust character of a deposit with it, it cannot, as against the true owner or person having a beneficial interest in or lien on the deposits, appropriate or claim the deposit as a set-off against a personal obligation of the Trustee-depositor to the Bank (3 Ency. U. S. Sup. Ct. Rep. 25; *7 Corpus Juris*, p. 660; *National Bank* v. *Insurance Co.*, 103 U. S. 783; *National Bank* v. *Insurance Co.*, 104 U. S. 54, 64, and cases therein cited; *Allen* v. *St. Louis Bk.*, 120 U. S. 20, 40; *Union Stockyards Bank* v. *Gillespie*, 137 U. S. 411, 416, 419, 420, 423; *ex parte Kingston*, 6 L. R. (Ch. Ap.) 632; *Gable Savings Bank* v. *National Bank of Commerce*, 64 Neb. 413; 89 N. W. 1031; *Baker* v. *New York Nat. Bank*, 100 N. Y. 31; 2 Michie on Banks & Banking, § 134; 1 Morse on Banks and Banking, 5th Ed., § 326 (*f*) 334; *Allen* v. *Puritan Trust Co.*, 211 Mass. 409; 55 L. R. A. (n. s.) 518, 525 monographic note; *Walters National Bank* v. *Bantock*, 41 Okla. 153, citing many authorities: 3 R. C. L. 593; *Clemmer* v. *Drovers Nat. Bk.* 157 Ill. 206; *Burtnett* v. *First National Bank*, 38 Mich. 630, 635; *Boylen* v. *N. W. Nat. Bank*, 125 Wis. 498; *Emigh* v. *Earling*, 134 Wis. 565).

SECOND POINT.

The Banks accepted the deposit with full knowledge that the Butterworth-Judson Co. made the deposit for the express purpose of having the money applied by its own checks to certain specific purposes.

Therefore, the Banks cannot assert the right of set-off against the deposit.

1. The Banks, at all times, knew that the $1,500,000, and any replenishments thereof, were in special accounts, separate and distinct from all other property and funds of the Butterworth-Judson Co.; that it was required to be kept so differentiated, ear-marked and distinct; that the deposit had been made for the purpose of facilitating the construction of the picric acid plant under the terms of the Principal Agreement of May 9, 1918; and that by the terms thereof the Butterworth-Judson Co. could only use the money in payment of expenditures for building the plant, or for manufacturing the acid for the Government as required by that contract (R. 30, 65).

2. The deposits were accepted by the Banks with full knowledge that the depositor (1) expected to check the money out for certain specific purposes only, and (2) was under express contract *not* to check the money out for any other purposes whatever.

By accepting the deposits with such knowledge of the Butterworth-Judson's intention as to its specific application, the Banks thereby waived, or are estopped to assert. any right of set-off against

such deposit on account of any indebtedness owing by the Butterworth-Judson Co. to the Banks.

3. This is not a case of what is often called a "special deposit" where something is left with the bank as bailee and the identical thing so deposited must be returned to the depositor.

This is a distinct class of deposit, where the depositor deposits money with the bank, title thereto passes to the bank as in the case of the ordinary general deposit, but where the depositor, *at the time of making the deposit, notifies the bank that the money is deposited for the purpose of being applied, by the depositor himself through the medium of checks drawn against it,* to some special object or purpose.

That is the case at bar.

It must be clearly differentiated from those cases (*a*) where the deposit, say, a bag of gold, is left with the bank which must return the identical physical gold, or (*b*) where money is deposited in a bank with instructions *to the bank itself to act as agent* for the depositor in applying the money to a designated purpose.

The present case belongs to an entirely different class, where the knowledge of the bank of the purpose to which the depositor has dedicated the money, and the acceptance of the deposit with such knowledge, prevent the bank from asserting its right of set-off, so as to defeat the application of the money to the designated purpose.

4. The Banks might have declined to accept the deposit. But when, instead of so declining, they accepted the deposit with the knowledge that it was deposited for certain specific purposes only,

the Banks cannot interpose any claim of their own in conflict with such specific purposes.

The Butterworth-Judson Co. had a right to determine the application of the money so deposited and accepted.

The fact that the Butterworth-Judson Co. had a right to check the money out (without countersignature on the checks of any other party), does not affect the question nor enlarge the right of the Banks to disregard the terms on which the deposit was made and accepted.

5. If, then, a bank cannot "set-off" its indebtedness against such a deposit, where *the depositor* determines the purposes for which he will check the money out, *a fortiori*, the banks cannot set off their indebtedness where the deposit is made by the depositor, *pursuant to a contract with the person furnishing the money* which stipulates that the money should only be checked out for certain specific purposes.

6. Eliminating, for the moment, the rights of the Government under the requirement that the money should be deposited in a special account, we have a case where the Butterworth-Judson Co. itself had the right, on depositing money to its credit, to notify the Bank that such deposit was put there for the purpose of being used by the Butterworth-Judson Co. for certain specific purposes only, and when the Bank accepted the deposit on those terms, it became bound thereby and could not seize the money in order to apply it to any other purpose.

THE BANKER'S RIGHT OF "SET-OFF".

(*a*) In the ordinary case of a deposit of money in bank, the relation of debtor and creditor arises (*Marine Bank* v. *Fulton Bank,* 2 Wall. 252; *Burton* v. *U. S.,* 196 U. S. 283, 301, and cases there cited).

The obligation of the bank is simply to repay the money on demand, as evidenced by the depositor's check drawn against the deposit; and (in the absence of notice to the bank that the depositor is guilty of some breach of trust in withdrawing the funds) the bank is not concerned with the application of the money (3 Encyl. U. S. Sup. Ct. Rep. 27; *National Bank* v. *Insurance Co.,* 104 U. S. 54, 65; *Union Stock Yards Bk.* v. *Gillespie,* 137 U. S. 411, 416; *Bodenham* v. *Hoskins,* 13 Eng. L. & E. 222; *U. S. F. & G.* v. *Adoue,* 104 Tex. 379).

(*b*) From that relation of debtor and creditor, there arose (1) by the law merchant the so-called banker's lien on securities and valuables in his hands, and (2) the right to set off a deposit against an indebtedness due the Bank (3 R. C. L. 589; *Brandao* v. *Barnett,* 12 C. & F. 787, 805, 806; *Shuman* v. *Citizens State Bank, 27* No. Dak. 599; *Wagner* v. *Citizens Bank,* 19 Ann. Cas. 483, 487 and monographic note).

(*c*) But this right of set-off is not absolute and unconditional. There are limitations upon it. *It does not exist* where the deposit *was made for a specific purpose* or under circumstances *inconsistent* with the existence, continuance or application of the right of set-off (*Reynes* v. *Dumont,* 130 U. S. 354, 390, 391; *Hanover Nat. Bank* v. *Sud-*

dath, 215 U. S. 110, 116; *Callaham* v. *Bank of Anderson,* 69 S Car. 374; 2 Ann. Cas. 203, 206 and monographic note); or if the deposit is *specifically applicable* to some other particular purpose (7 Corp. Jur., pp. 631, 632 n 10, 660; 3 R. C. L. p. 595 n 17).

In 3 R C. L., p. 595, it is said:

> "The right of the bank to apply a deposit to the payment of matured indebtedness on the part of the depositor to the bank, does not exist in the case of a special deposit or *a deposit for a specific purpose inconsistent with the right of application or set-off.*"

At page 588, the bank's right of set-off is recognized

> "provided there is no express agreement to the contrary and the deposit is not *specifically applicable to some other particular purpose.*"

In 2 Michie on Banks and Banking, § 134 (4) it is said:

> **"Deposits made for special purposes.** It is a general rule that funds deposited in a bank *for a special purpose,* known to the bank, or under a special agreement, can not be withheld from that purpose, to the end that they may be set off by the bank against a debt due to it from the depositor.
>
> **A custom among banks to apply deposits for special purposes** to debts due the bank from the depositor does not authorize such application.
>
> **Deposits to pay Designated Debts.** A bank does not have a lien upon special deposits of moneys deposited for the payment of a particular designated debt."
>
> **Deposit to meet Outstanding Checks.** A bank receiving a deposit with notice that

it is made to meet outstanding checks may not charge the depositor's account with a debt due it from him."

Again, page 1040:

"It is only where there gather around any particular deposit, or line of deposits, circumstances of a peculiar nature, which *individualize* that deposit, or line of deposits, and inform the bank of *peculiar facts of equitable cognizance* that it is debarred treating the deposit as that of money belonging absolutely to the depositor. The knowledge which *peculiar circumstances* casts upon a bank in respect to particular deposits is not limited to the character of the business of the depositor, that of commission merchant, *but extends to its results.*"

That language was adopted as the law of this Court in *Union Stock Yards Bank* v. *Gillespie,* 137 U. S. 411, 416.

In Morse on Banks and Banking (5th Ed.), § 325, p. 611, it is said:

"Any special purpose attaching to the deposit *inconsistent* with a general lien will prevent it, * * *".

§ 325 (*b*) "No General Lien if Bank has Notice of Facts Inconsistent with it, as a Special Purpose in the Deposit. "(*b*) In *Bank of United States* v. *Macalester,* the general rule was laid down that funds deposited in a bank for a special purpose, known to the bank, cannot be withheld from that purpose, to the end that they may be set off by the bank against a debt due to it from the depositor. Accordingly, certain coupons of the State bonds, issued by the State of Illinois, having been made payable at the Bank of the United States, and funds to pre-

cisely the amount necessary to meet these coupons having been deposited by the State in the bank just before they fell due, it was held that the bank, understanding the purpose of the deposit, could not refuse to apply the money to the payment of the coupons on the ground of a prior undischarged indebtedness of the State to the bank. The same general rule is laid down by Grant in his English Treatise, p. 372. He says that the claim of a general lien by the bank would be inconsistent with its special undertaking.
* * *

The English cases eliminate from the operation of the lien all property which comes into the banker's hands plainly earmarked or *appropriated for any special purpose.* A customer's security, specifically stated to be for the amount 'which shall or may be found due on the balance of his account', was held to be security for the then existing balance only, and not to be applicable upon the subsequent floating balance. In like manner, a security specifically given for a contemporaneous advance of one thousand pounds by the banker, was held not to be applicable against an independent indebtedness of five hundred pounds, afterwards arising upon the ordinary running account."

In 1 Morse on Banks and Banking, § 325 (*d*), it is said:

"Specific Deposit can not be appropriated to debt of the Depositor to Bank. Money deposited *for a specific purpose* must be applied to that and no other. Where a State had two deposits in a Bank, one to pay coupons and bonds issued by the canal commissioners, the other under control of the fund commissioner, the latter being overdrawn, the bank applied the former deposit

to settle the deficit. *Held,* that this could not be done by the Bank; it was the agent of the coupon holders to the extent of the sum set apart for their payment."

p. 626, it is said:

"And if there is any circumstance *inconsistent with the claim of a lien,* it will not be upheld, as where securities are delivered to a bank for a specific purpose."

In *German National Bank* v. *Foreman,* 138 Pa. State, 474, the Court explained that the meaning of the limitation of the right of the depositor to deposit his money for a special purpose, was this:

"It means merely that where a depositor has made a *special* application or *appropriation of his balance and so notifies the Bank,* the latter cannot charge off the note against his deposit. *This arises from the fact that a man may do what he will with his own, so long as he retains control of it."*

In *Masonic Savings Bank* v. *Bangs' Admr.,* 84 Ky. 135, 139, it is said:

"It is equally as well settled that when the deposit is made for a special purpose, with the knowledge and undertaking of the bank, that purpose must be carried out."

The English rule as established in *Brandao* v. *Barnett,* 12 C. & F. Rep. 787, 786, *Bock* v. *Gorissen,* 30 L. J. (ch) 39, and *T. H. Greenwood Teal* v. *William Williams Brown & Co.,* 11 T. L. R. 56, and as adopted by this Court in *Reynes* v. *Dumont,* 130 U. S. 354, 391, is that a banker's lien or right of set-off will not arise where the deposit or security has been accepted by the

banker under conditions *inconsistent* with the claim of a lien or right of set-off.

A chronological review of the authorities covering this particular special class of deposits will show the development of the law. We will exclude therefrom those powerful cases which might be said to be based on the existence of a trust (*National Bank* v. *Insurance Co.,* 104 U. S. 54) and those where the Bank itself agreed to disburse the money as agent of the depositor ( ).

The principle for which we contend is a development of the past fifty years and can best be understood by a

CHRONOLOGICAL REVIEW OF THE AUTHORITIES.

In *Wilson* v. *Dawson,* 52 Ind. 513, 515 (1876), a depositor, being indebted to a bank, agreed with the bank that he would buy cattle, deposit the proceeds with the bank, give to the seller checks for the amount, and that the deposit should be applied exclusively to the payment of the depositor's checks to such sellers. The Court held that the bank had no right to set-off the deposit against a past due note, saying:

> "It is clear, we think, however, that as the money in question was deposited under a special agreement that it should be paid out and used only in satisfaction of the checks drawn in favor of the persons from whom the cattle, etc., had been purchased, from the sale of which by the principal in the note the money had been derived, it could not have been rightfully applied to the satisfaction of the notes on which the action is predicated."

The bank was not an agent to make the payment or application of the money, but it was simply to honor checks drawn in the ordinary manner against the account for a specific purpose. It may be suggested that the money deposited was a trust fund belonging to the owners of the cattle. The depositor was not a factor or agent, but a buyer. The Court put its decision upon the ground that, as the bank knew that the funds *were deposited for a special purpose*, it could not prevent the carrying out of such purpose, saying:

> "It is a general rule, that funds deposited in a bank for a *special purpose*, known to the bank, cannot be withheld from that purpose, to the end that they may be set-off by the bank against a debt due to it from the depositor. The claim of a general lien by the bank would be *inconsistent* with its special undertaking. Morse on Banks & Banking, 34 *et seq.*, and authorities cited; *Bank of U. S.* v. *Macalester*, 9 Pa. St. 475. * * * Had it not been for the special agreement made by the bankers, *it may be presumed the money never would have been deposited with them.*"

In *Straus* v. *Tradesmen's National Bank*, 36 Hun, 451 (1885), one Dixon gave his accommodation check for $11,775 to the plaintiffs when there were no funds in bank to meet it. The plaintiffs sent their certified check to the bank with instructions to deposit it to the credit of Dixon in order to meet the check Dixon had given the day before. The bank deposited the check to Dixon's credit and then proceeded to offset a portion of the deposit against a debt Dixon owed the bank. The Court held that as the bank *accepted* the deposit to Dixon's credit *knowing that it was intended to meet a check* Dixon had previously

drawn, it could not set off the deposit against its own indebtedness, saying:

> "From this statement the fact clearly appears that the plaintiffs' check was deposited with the Tradesmen's National Bank to the credit of Dixon, solely for the purpose of paying the check received from him by the plaintiffs. And the bank having so received it, *understanding that to be the intent and object of its deposit, legally accepted the trust created by the transaction and became obligated to appropriate so much of the plaintiffs' check as should be required for that purpose to the payment of the check loaned to them by Dixon.* It was *not necessary* for the creation of this obligation that the officers of the bank should *expressly agree* so to use and apply the plaintiffs' check. The obligation to do that very clearly arose out of the delivery of the check to the bank *with notice that such was the object of its delivery without any concurrent promise on the part of the officers of the bank to carry that object into effect.* Their conduct was such as to disclose their *acquiescence* in the purpose for which the check was delivered and received, and out of that the obligation plainly arose to apply its proceeds solely and specially as the plaintiffs intended they should be applied. A *trust* to this extent was created in the plaintiff's favor, and the bank had no right or authority to use any part of the proceeds of the check for a different object. (*United States* v. *State Bank*, 96 U. S. 30, 35; *National Bank* v. *Insurance Co.*, 104 U. S. 54; *People* v. *City Bank of Rochester*, 96 N. Y. 32, 37.)"

This judgment was ultimately affirmed in 122 New York, 379 (1890), when the Court said:

> "* * * it must be assumed that the defendant had notice that the deposit was spe-

cially made to supply a fund to pay the Dixon check. This check had been indorsed by the plaintiffs, and placed to their credit in the Hanover Bank, when their check on that bank was certified. And, as between them and Dixon, the latter had no right to divert the fund produced by the deposit in the Tradesmen's Bank from its purpose and subject them to liability upon the indorsement so made of his check. The plaintiffs' check represented their money, and was deposited with the bank to carry out their agreement with Dixon; and this being accomplished they would also be relieved from liability as such endorsers. When the defendant received it, with notice that the deposit was made to pay a check given by Dixon to the plaintiffs, it was denied the right to treat the fund as a general deposit on Dixon's account; and it must be deemed to have been placed to the credit of Dixon subject to the qualified purpose or trust on which the defendant was then advised the deposit was made. *Van Alen* v. *Bank*, 52 N. Y. 1; *People* v. *City of Rochester*, 96 N. Y. 32; *National Bank* v. *Insurance Co.*, 104 U. S. 54."*

n *Fitzgerald* v. *State Bank*, 64 Minn. 469 96), a firm became insolvent, the creditors met, uding the cashier of a bank and it was agreed during the absence of the senior member of firm in Europe, one Miller should carry on the ness, collect in the assets, deposit the money ne bank and not pay out any money upon the ting indebtedness of the firm. The Court

*It may be suggested that the Bank was an active t to apply the deposit. But it was not to do anyg except, as here, to place the deposit to Dixon's unt so as to meet his check when presented.

held that the bank could not off-set a deposit against a debt it held against the firm. The Court said:

> "It was in the nature of a special deposit for a *well understood purpose and object.* Certainly good faith and fair business dealing require that the amount of this deposit shall not be so diverted as to give a party to the agreement a preference over other creditors. So the question is whether the law will permit the bank which received the money under such circumstances to set off notes held by it against the insolvent firm to the amount of the deposit, and thus indirectly obtain a preference. If this could be done, the plainest principles of *equitable estoppel* would be disregarded, for undoubtedly the acts and conduct of the cashier, when present at and presiding over the meeting, influenced other creditors, and they were of such a character that to allow the bank to now repudiate them, or any part of the transaction, and to appropriate the amount of the deposit in part satisfaction of its notes, would be rank injustice, necessarily resulting in injury to the creditors who participated in the meeting and in the agreement, as well as to all other creditors of the insolvent firm. The money acquired by Miller belonged to all of the creditors, and the nature of the agreement under which Miller obtained and placed it in defendant's custody shows that the cashier understood and recognized the fact. The Bank cannot now dispute the right of the assignee to the money."

In *Carter* v. *Martin*, 22 Ind. App. 445 (1899), an owner agreed with a contractor to make an *advance payment* on account of a building which the contractor was erecting for the owner. The

contractor deposited it in bank under an agreement that the contractor should check against it for the payment of material and labor going into the building. The bank knew at the time of receiving the deposit that the contractor had received it as the first payment on the contract and that he had no other means with which to pay for the material or labor on the building.

The Court held that the bank could not treat that deposit as a payment of a debt owing by the contractor to the Bank, saying:

> "When appellees [bankers], received said money from McCormick under said agreement to pay it out upon his order in satisfaction of certain claims, they lost all control of it, so far as disposing of it in any other manner than as was agreed at the time the money was received. * * *
>
> Nor does this view of the law, as applicable to the facts in the cause, in any way conflict with the well-settled rules of law as applied to banks. Appellees were doing a banking business. They accepted the $575 from McCormick as a deposit, but they accepted it under a special agreement as is shown by the finding of facts. Where one indebted to a bank makes a general deposit, the bank may appropriate such deposit to the payment of said indebtedness. Such right may be waived by the bank * * *."

In *Woodhouse* v. *Crandall,* 197 Ill. 104 (1902), it was held, that where a depositor deposited $1,500 with a bank which knew that the deposit was made pursuant to a lease by which the depositor was to deposit the money to secure performance of the lease, the banker had no general lien. The money was mingled with the banker's general funds, but was held that it is the ***fund,*** not the ***particular bills,***

which is subject to be followed, traced and identified. The Court said:

> "The material question in this case, therefore, is whether the trust fund deposited by Furlong can be traced and identified, and upon that question the law is well settled that it is not necessary the money or bank bills should be identified. The suit is not to recover a specific thing, such as particular pieces of money or bills, but a certain sum of money held in trust, and *it is the identity of the fund,* and not the identity of the money or currency which is to be established.
>
> It makes no difference, then, in tracing this fund, that the original package of bills was not preserved, but the question is whether the *trust fund* can be followed and found. * * *
>
> Again it makes no difference on the question of identity that the fund was mingled with other moneys of the bank. That question was also settled in *Kirby* v. *Wilson,* 98 Ill. 240, where it was held that the identity of the fund is not destroyed and lost merely by being mingled with other moneys of the trustee."

In *Lynam* v. *Belfast Nat. Bank,* 98 Me. 448 (1904), a corporation got in financial difficulties, the creditors met, at which a bank was represented. Before any bankruptcy proceedings were started, the company deposited $800 in the bank with the intention (although not communicated to the bank) that the money should be held for its trustee in bankruptcy when he should in the future be appointed. The Court held that the bank could not off-set a debt against the deposit, saying:

> "Since June 10th the granite company had ceased to be a going concern, and all its efforts and that of its creditors had been to obtain a distribution of its assets equitably,

and to that end the first attempt was to discharge the attachments. Honest dealing on the part of the granite company, which is to be presumed, required that all its assets should be husbanded for the benefit of all of its creditors. Pending the effort to obtain an assignment or adjudication of bankruptcy, it had $800 in money, which it intended to retain, and ought to retain, as part of its general assets. As some time would elapse before it could be thus administered, it was deposited in the bank, really for safekeeping. All these facts were well known to the bank when it received the deposit. It knew it was not intended as a payment, and did not treat it as such. The bank could not fail to understand that it was intended that this money should be added to the other assets for the general benefit, as it equitably ought to be. It certainly understood that the granite company, under the then existing circumstances, *would not voluntarily subject this portion of its assets to a set-off by the bank, to the injury of other creditors.*

Upon consideration of all the circumstances, and the situation of the parties, we think it a fair inference that the bank understood that the deposit was intended only for safekeeping, to be ultimately appropriated for the benefit of all the creditors of the granite company, and that in fact it was a deposit in trust for that purpose. And it being charged with such trust, the plaintiff, as trustee in bankruptcy, is entitled to recover."

In the case at bar, Counsel for the Banks attempted below to distinguish the *Lynam* case by saying that the bank

> "had knowledge of the existence of a fiduciary relation between the depositor and a third party [the Trustee in bankruptcy] and hence could not offset the account."

Such is not the case.

At the time the bank received the $800 deposit, no Trustee in bankruptcy had been appointed, no bankruptcy proceedings had been started, and no fiduciary relations existed between the depositor and any third person, and the deposit was made with the simple statement "Enclosed find deposit credit S G Co. $800" and was treated as an ordinary deposit. The right of set-off was denied, however, upon the ground that the Bank, although not expressly notified, must have known that the deposit was not made with the intention of letting the Bank appropriate it, but was intended to be held for future disposition by a Trustee in Bankruptcy if and when he should be appointed.

The attempted differentiation fails, and the case is directly in point. The right of set-off was denied because, on the facts, it was held that the bank must have known that the depositor *did not intend* the deposit as a payment of the Bank's debt. *A fortiori,* in the case at bar, the Banks knew that the deposit of the advance payment was not intended to be applied to the Butterworth-Judson Co.'s debts or general purposes, but was by contract specifically required to be segregated and held for the specific purpose of meeting the expenditures in the erection of the plant and the manufacture of picric acid.

In *First National Bank* v. *Barger,* 115 S. W. 726 (1909), one Coldwell drew four checks upon a bank in which he had no funds, and to which he was already indebted. He met the President of the bank in a different city, gave him another person's check for the exact amount of the checks issued and asked him to place it to his (Cold-

well's) credit; and he told the President of the checks he had drawn which would be protested if they reached the bank before the one he handed the President. The President mailed the check to the bank without any statement of the purpose of the deposit. Upon the return of the President to the bank, the check was credited to Coldwell and against it was charged the prior indebtedness.

The Court held that the bank could not set-off the indebtedness against the deposit, because it received the deposit with notice that it was made for the purpose of meeting certain outstanding checks drawn by the depositor.

The Court said:

> "The law is that, if a bank received a general deposit from one who is indebted to it, the bank has the right to charge the depositor's account with such indebtedness; but if the bank received a deposit with notice *that it is made for the purpose of meeting outstanding checks* drawn by the depositor, it has no right to charge the depositor's account with sums due it by the depositor, and thus defeat the person holding the outstanding claims from collecting their checks. This rule applies only when the bank has *notice* of the previous appropriation of the sum deposited, or, in other words, that it is a special deposit to meet outstanding checks issued by the depositor."

In the case at bar, the Banks knew when they accepted the "special account" deposits that, by contract between the United States and Butterworth-Judson Co., the $1,500,000 deposited had been dedicated to a specific purpose, *i. e.,* to meet payments for building the plant and making the acid thereat.

In *Wagner* v. *Citizens Bank, etc., Co.*, 122 Tenn. 164 (1909), a furniture company became financially embarrassed. The local creditors, including a bank, met, and with the consent of the officers of the company, agreed that the assets should be converted into cash, and be deposited to the company's credit in the bank; that out of the deposit they would pay current expenses and satisfy the claims of any persistent creditors, and then after the accumulation of sufficient funds had been made, the funds should be divided among local and foreign creditors *pro rata*. Checks were to be signed by the President of the Furniture Co. and countersigned by a representative of the Creditors' Committee.

The proceeds of all sales were deposited in the bank. The bank attempted to set off the deposit against an indebtedness due it by the Furniture Company. The Court (citing many authorities) stated that the general rule was that the relation between a bank and a depositor was that of debtor and creditor, and that a bank could set off a deposit against an indebtedness; but the Court (reviewing various authorities, some of which are noticed above) denied the right of set-off upon the ground that the bank knew when it accepted the deposit

> "that this fund was being deposited with it as a special fund for *pro rata* distribution among all the creditors of the Wilcox Furniture Co."

After distinguishing certain cases asserting the ordinary rule of set-off, the Court concluded:

> "We are therefore of opinion that the bank is *estopped*, by its conduct and by its agreement with the other creditors, from asserting

any right to a set-off against the funds derived from the sales of the stock of the Furniture Company."

In *Smith* v. *Sanborn State Bank,* 147 Ia. 640 (1910), a depositor left with a bank a $200 Bill of Exchange, telling the bank that he desired to use the money (*a*) to pay a $40 rent claim held by the bank for collection, and (*b*) the remainder to pay the medical expenses of his wife who was to be sent to a hospital in a distant city the next day. The bank told the depositor that the safe was locked for the night, but that he could leave the Bill of Exchange as a deposit, together with a check for $43 to cover the rent claim and another $3 indebtedness to the bank, and that the remainder could be drawn by him as the money might be needed in the treatment of his sick wife. Later the bank charged up the remainder of the deposit against a promissory note which the depositor owed to the bank.

It should particularly be noticed that the bank did not itself undertake to pay out, as agent, any money for and on behalf of the depositor, but that it merely told him that he would be able to check on the account for the purposes that he wished to accomplish in making the deposit. This is a direct analogy to the case at bar where the Banks accepted the deposit with full knowledge that the Butterworth-Judson Co. was going to check out the money for certain specific purposes as required by its contract.

When the Banks accepted the deposit with that knowledge, it was equivalent to an agreement by them that the Butterworth-Judson Co. could check the money out for such purpose.

In holding that the bank had no right to set-off the deposit against the note, the Court said:

> "Of the general rule that a bank to whom a depositor is owing a matured indebtedness may appropriate the general deposit of its debtor to the discharge of the obligation, there can be no doubt. *Aetna Nat. Bank* v. *Fourth Nat. Bank,* 46 N. Y. 82, *Knapp* v. *Cowell,* 77 Iowa, 528. But it is no less certain that a deposit *made for a special purpose,* or under a special agreement, cannot rightfully be so appropriated. *Wilson* v. *Dawson,* 52 Ind. 513; *Straus* v. *Tradesman's Nat. Bank,* 122 N. Y. 379; *Judy* v. *Farmer's & T. Bank,* 81 Mo. 404; *Bank of United States* v. *Macalester,* 9 Pa. 475; *Masonic Sav. Bank* v. *Bangs,* 84 Ky. 135. Indeed, the proposition that a bank enjoys no exemption from the general rule by which every party to a business transaction or agreement is legally bound to respect the obligation of his contract is one which ought to require neither argument nor citation of authority. The evidence shows without dispute that the check for $200 was placed with the defendant upon the express agreement and understanding that, after paying certain specifically named debts, the remainder would be repaid to the plaintiff on the following day, or whenever called for, to enable him to take his wife to the hospital for needed treatment. Upon money so received, no lien attached in favor of the bank, and its attempt to appropriate the same was wholly without right or authority. Upon such a record plaintiff was clearly entitled to recover."

In the case at bar, when the Banks accepted the $1,500,000 "special account" deposit, with knowledge of the terms on which alone the depositor [Butterworth-Judson Co.] was authorized to de-

posit, they *impliedly agreed* to such terms, became bound to honor the depositor's checks, and renounced their right of set-off, which could not attach to funds so accepted.

In *Dolph* v. *Cross,* 153 Ia. 289 (1911), a man drew a check upon a bank, and thereafter deposited funds in the bank to meet the check, telling the bank that the funds so deposited were deposited to meet the payment of checks already drawn. The bank refused to honor the checks when presented, on the ground that an intermediate garnishment had been served.

In holding that the deposit could not be reached by the attaching creditor of the depositor, the Court said:

> "The bank officials understood that they received this money for the *express purpose* of paying checks already issued for that exact amount. Whether the facts pleaded show an equitable assignment to the check holders we need not determine. The deposit was special, and not general. It was made for the benefit of the particular check holders. The bank received it as such. It is enough to say that the contract of deposit was made for the benefit of third parties, and that such third parties were entitled to avail themselves of it. *If the bank itself had been a creditor of the depositor, it could not have applied such deposit upon its own claim.* * * *
>
> *The bank, having received the deposit for such specific purpose, was bound by the conditions imposed.* * * *
>
> We reach the conclusion that the deposit in question was *special,* and not general, and that it did not create the mere relation of debtor and creditor between the bank and the depositor in the ordinary sense, and that the

> right of the check holders, for whose benefit it was deposited, was superior to that of the garnishing creditor, and that the claim of the intervenor thereto to the amount of his check should have been sustained."

In *Walters Nat. Bank* v. *Bantock,* 41 Okla. 153 (1913), a Realty Company deposited $1,000 to its credit. The bank was notified that this deposit was made so that the Realty Company could give its check against it, to be held with a check of like amount by another man to insure the faithful performance of the contract for a sale of real estate. Later the bank "set-off" against the deposit an indebtedness it had against the Realty Company.

The Court held that this could not be done, because the Bank knew the purpose for which the $1,000 deposit was made, and had assured the parties that when checked on, the check would be paid.*

In *Peterson* v. *Crawley,* 38 So. Dak. 597 (1917), by agreement between a mortgagor and mortgagee, $800 of the proceeds of fire insurance on the mortgaged property, was turned over to a bank cashier to be deposited in his name and to be used by the mortgagor for the purpose of erecting a new house on the premises. Later, the mortgagor determined not to rebuild and sent to the mortgagee a check for $800 drawn on the bank as a partial payment on the mortgage debt. The bank refused to honor the check upon the

* If it be suggested that the bank expressly promised that the check would be honored when presented, we respond that such promise is no more effective than the Banks' implied promise, on receiving the Butterworth-Judson Co. deposit, to honor checks drawn against it.

ground that it had set off the deposit against a debt owing it by the mortgagor. The Court held that, as the money was deposited with the bank *for the sole purpose of being applied to the erection of a house on the mortgaged premises,* the mortgagor had the right to direct that the amount so deposited should be applied to the reduction of the mortgage indebtedness.

The Court said:

> "The evidence conclusively shows that the Cashier Randall, was fully advised as to the purpose for which the deposit of $800 was made in his name, and that it was not a deposit for the use and benefit of Crawley himself nor the Bank. The bank itself was charged with this knowledge of its cashier, and had no more right to appropriate this deposit to its own use than would Randall himself. The bank accepted the deposit with full knowledge, that the same was not intended to become, and did not become, any part of Crawley's personal funds or deposit, and the fact that the fund was so deposited in the name of Randall, its cashier, gave the bank no right to appropriate the deposit in satisfaction of Crawley's indebtedness to the bank. It is clear that neither the bank nor Randall, the cashier, had any interest in or control of the fund so deposited, *except such as was expressly conferred by the agreement of Mrs. Peterson and Crawley.* We are of opinion that this fund constituted a *special deposit* in Randall's name for the sole use and benefit of Mrs. Peterson and Crawley, and that they had the legal right to dispose of it, as they did, in applying it in part payment of plaintiff's mortgage. The record conclusively shows that Mrs. Peterson and Crawley *had agreed to this application of the*

> *fund* long before any attempt was made by the bank to apply it in satisfaction of Crawley's indebtedness to the bank."

In *Lehigh Valley Coal Sales Co.* v. *Maguire,* 251 Fed. 581 (1918), a seller refused to ship any coal unless paid for in advance. The purchaser sent an order for coal and a certified check in payment. The purchaser went into bankruptcy. The seller refused to ship the coal and retained the check as a credit upon an outstanding indebtedness. The Court (C. C. A., 7th Cir.) held that this could not be so set-off. After distinguishing *N. Y. County Bank* v. *Massey,* 192 U. S. 138, which was an ordinary case of a bank and a depositor—debtor and creditor—the Court said:

> "But where a creditor receives money from his debtor, with instructions not to apply it on the debt, but to hold or use it for a specific purpose, the right of set-off does not exist, because the *creditor* has become, not the debtor of his debtor, but the *trustee of a specific trust*" citing various Federal cases.

In *Turkington* v. *1st National Bank,* 97 Conn. 303 (1922), Mrs. Johns bought some corporate bonds under an agreement that the money she paid for them would be deposited by the company in a separate fund in bank to be checked out by the company for the purpose of the construction and equipment of the mortgaged plant.

The deposit was duly made to the credit of the company in a separate or special deposit to be checked out only for the specified purposes. The treasurer of the corporation was also cashier of the bank, knew of the agreement between Mrs. Johns and the company-depositor and agreed that

the arrangement would be carried out. Later, the bank set off the balance of the deposit against a debt owing to it by the company. The Court held that the bank had no right to set off the deposit against its debt, saying:

> "It is too late for the bank to deny that it received this deposit as a *special deposit to be applied only to the purposes agreed on;* and even if it were found, as it is not, that the tobacco company was actually indebted to the bank in June, 1915, the law is well settled that in such cases a bank cannot assert a lien or set-off *inconsistent with its special undertaking.* Morse on Banking, § 325, and many cases cited.
>
> In this particular case Mrs. Johns still retained a *special property* in the fund. It is true that she had received her mortgage bonds, *but so long as the entire fund had not been applied to augment her security she had not received the entire consideration agreed for by the terms of the special deposit.* And in the meantime the fund was deposited with the bank which was a party to the agreement, and has had the use of the money in its business. That being the situation it is perfectly clear that the bank had no right to appropriate any part of the fund in satisfaction of a claimed indebtedness of the tobacco company incurred in the ordinary course of its business."

In the lower courts, counsel for the Banks attempted to distinguish the *Turkington* case by saying:

> "In the *Turkington* case, therefore, the bank received the money as a special deposit for certain purposes only. These having been fulfilled, and a balance remaining, the banks

had no right to appropriate the balance to the payment of a debt due itself from the depositor. The special objects having been performed, the balance had to be returned. This was *not a general deposit* to be drawn on by check of the depositor without restraint by the bank."

The attempted differentiation fails, because in the case at bar the Banks received the $1,500,000 special account deposit as absolutely for the specific purposes named in the contract as did the Bank in the *Turkington* case. The contract in the *Turkington* case is excerpted in the margin and is no more specific than the contract in the case at bar.*

In the case at bar the deposit was no more a general deposit (to be withdrawn by the depositor without restraint) than could be done in the *Turk-*

*DEAR MADAM: We hereby acknowledge the receipt of your certified check for $28,500 payable to our order, the same being in payment for thirty-first mortgage bonds of this company.

"It is understood and agreed by the company that the $28,500 aforesaid will be deposited in a separate fund in the First National Bank of New Milford and checked out only for the following purposes:

"(1) On account of the expenses of the construction of the new mill at Wellsville, where the plant is located.

"(2) On account of the purchase of machinery and other necessary equipment for the same.

"(3) On account of the repair, improvement or necessary equipment of the present factory and property at Wellsville now owned by the company.

"(4) Commission of brokers in connection with the sale of bonds to you.

Yours very truly,
(Signed) TOBACCO PRODUCTION COMPANY,
By E. J. STURGES, Treasurer.

"As cashier of the above bank I guarantee that the above will be carried out.

"E. J. STURGES, Cashier".

ngton case. In each instance, the bank had full knowledge of the promise of the depositor that he deposit should be kept in a separate fund and hecked out only for certain specific purposes. The Butterworth-Judson Co. had no more control ver the deposit than did the Tobacco Company n the *Turkington* case. In each case, the Banks ad the same, and no more, responsibility for the pplication of the money; and the same, and no ore, right of set-off in the one case than in the ther.

In *Continental National Bank* v. *Moore*, 299 ed. 270, 272 (1924), a purchaser of a merchant's tock of goods, deposited the money in a bank to he order of the merchant with instructions to ay it over to him on receipt of a bill of sale, reerving to the purchaser the option to recall the oney if claims in excess of a certain amount ere filed against the merchant. The bank aplied the deposit to the payment of one of its own ebts.

The Court (C. C. A., 9th Cir.) held that the ank could not do so, saying:

> "The right of set off attaches upon the moneys of a customer deposited with the Bank 'in the usual course of business for advances which are supposed to be made upon their credit'. Michie, Banks and Banking, § 134. As to the fund which represented the proceeds of the bankrupt's business, the relation between the appellant [bank] and the bankrupt [merchant] was not that of banker and depositor, but that of bailee and bailor. * * * As to the funds so placed in the control of the bank it is well settled that there was no right of set-off" citing four Federal cases not reviewed herein.

THIRD POINT.

Analysis of the opinion of the Circuit Court of Appeals, and a Response to certain contentions of the Banks.

I.

ANALYSIS OF CIRCUIT COURT OF APPEALS' OPINION.

The Circuit Court of Appeals held:

I. That the transaction was exactly what it purported to be, *i. e.*, payment in advance for things purchased and thereafter to be delivered (R. 313, 314); and that the relation between the United States and the Butterworth-Judson Co. was not that of principal and agent (R. 315) but was one of debtor and creditor (R. 317).

COMMENT: That is correct. But the creditor (U. S.) by express contract reserved a special right in the fund, enforcible in equity.

II. That the only security which the United States took for the $1,500,000 advance was (*a*) a demand note for $1,500,000 (R. 316) and (*b*) a $750,000 surety bond (*Id.*)

COMMENT: That view is erroneous because *incomplete*, as it *omits* any consideration of the *principal* security taken, *i. e.*, the deposit of the money in a *special* account, *separate* from all other funds, and the *obligation* (secured by the $750,000 surety bond) that it should *not* be used for any other purpose whatever.

III. That because (*a*) the so-called "collateral" note bore interest and (*b*) the Butterworth-Judson Co. reserved the right to repay, at any time, to the Government any outstanding balance of the advance, *therefore* the relationship was simply that of debtor and creditor (R. 316, 317).

COMMENT: So far as that argument tends to prove the relation of debtor and creditor, it may be conceded.

But the Banks draw a *different* conclusion from that of the Court of Appeals, namely:

First: The Banks contend that the requirement of interest not only establishes a debtor-creditor relation, citing numerous cases,* but that it also, *ipso facto,* negatives the idea of any sort of fiduciary element in the transaction.

To that it may be replied (1) that no interest *was* required, as the original contract expressly provided in Art. XVII that as to the interest, if any, required by the War Credits Board,

> "the United States shall *reimburse* the Contractor therefor as a part of its costs and expenses under this contract" (R. 50).

(2) that there is no inconsistency whatever between the payment of interest and the existence of a trust relationship, as a single example will demonstrate. A will might provide that the executor or trustee, a Trust Company, should, on all

**Pittsburgh Nat. Bank* v. *McMurray,* 98 Pa. St. 538; *Cottonwood Co. Bank* v. *Case,* 125 N. W. 298; *Martin* v. *N. Y. Mining Co.,* 165 Fed. 398; *Budd* v. *Walker,* 113 N. Y. 637; *Preston* v. *Brennan,* 135 Cal. 55; *Blair* v. *Follansbee,* 67 Ill. App. 144; *Estate of Sam'l Deaner,* 126 Ia. 701; *Price* v. *Dawson,* 111 Misc. 279; *Kerchaw* v. *Snowden,* 36 Ohio St. 181.

uninvested cash balances in the estate, deposited in its banking department awaiting distribution, or reinvestment, pay 2% on such daily balances. No one could contend that the payment of that interest negatived the existence of a trust or relieved the executor or trustee from any fiduciary liability.

It is submitted, therefore, that the Government's contention that the $1,500,000 was impressed with the character of a trust fund, cannot be summarily disposed of by saying that the Butterworth-Judson Company was to pay interest.

Second: The Banks contend the Butterworth-Judson Co.'s right to repay the advance at any time also negatives a trust relationship. Not at all. Any express trustee may stipulate that he can return the trust fund at any time. But, in fact, we do not here have to rely on a *formal express* trust. We have a fund where title and possession have passed, but where the grantor retains such a *special interest* in its disposition as to create an *equitable lien* in respect thereof, or at all events to impress the fund with certain characteristics of a trust.

It is thus seen that the positions of the Court of Appeals and the Banks are very different. The former relies on the provision for interest and a bond as establishing the debtor-creditor relation (which we concede); while the latter rely on such provisions as conclusive evidence that no fiduciary element can exist (which we dispute).

IV. That no trust fund was created, because there was "neither designated beneficiary nor a designated trustee who is not the beneficiary", cit-

ing a trust fund definition in *Brown* v. *Spohr*, 87 App. Div. 522, 529 (R. 317).

COMMENT: Without stopping to inquire as to the universal correctness of the definition quoted, it is sufficient to observe:

We are not dealing here with a formal trust fund, granted by A to B for the benefit of C, but we are dealing with that species of equitable right where, *as between the parties, and those taking with notice,* it is competent to contract with respect to personal estate, so as to create an *equitable lien,* enforcible by the injured party, in equity, without being remitted to an action at law for damages for breach of contract (see authorities cited, pp. 30-38, *supra*). But, as pointed out (p. 28, *supra*), many writers would hold the Butterworth-Judson Co., on depositing the money in bank, became (1) an express trustee of the *chose in action* [claim against the bank] for the benefit of the United States, and (2) charged with the fiduciary duty to apply the fund strictly to the purposes set out in the contract.

V. That no "revolving fund" was created (R. 317, 318).

COMMENT: While the provisions for the constant replenishment by the Government of the $1,500,000 advance, as fast as it was used in erecting, etc., the plant (Art. VI, R. 42; Art. VI, R. 65) might well be termed a "revolving fund", yet, in so far as the Court means to hold that the $1,500,000 became an advance payment to Butterworth-Judson Co., and did not remain exclusively Government money disbursed by it through the contractor as an agent, its position may be conceded.

VI. That the effect of the "special account" was not "to keep the title of advance payments in the United States" (R. 319).

COMMENT: That is conceded.

II.

RESPONSE TO BANKS' CONTENTIONS BELOW.

I. *"Special account" was not confined solely to erecting plant.* The Banks insisted that the $1,500,000 could be used (*after* the completion of the plant) in the production of the picric acid at the plant. *That is conceded by the Government,* but it is not observed how that helps the Banks' position.

II. *Duty of Banks to honor checks of Butterworth-Judson Co.* The Banks insisted that they were bound to honor any checks drawn by the contractor against the "special account" and rely on that fact as proof that no trust element existed. It is *conceded* that (in the absence of any express knowledge that the contractor was checking out the money in violation of its duty) the Banks would have to honor checks and were not bound to look to the application of the money. But how does that fact give to the Banks any right of "set-off" in conflict with (1) the equitable lien of the United States, or (2) its obligation, on accepting the deposits, to permit it to be used for the specified purposes?

III. *Special Deposit.* The Banks cited several authorities to show that a special deposit is one where the title never passes to the Bank, which is a mere bailee, bound to return the *identical thing*

deposited.* *That is also conceded;* but the case at bar is not one of special deposit in that sense, but it is one where the Bank accepted the deposit with knowledge (and hence with implied agreement) that it was to be applied only to certain specified purposes—and hence *inconsistent* with any right of "set-off".

IV. *Demand Note.* The Banks urged that the Butterworth-Judson Co. was to pay interest on the $1,500,000 note, and that the correlative promise of the Government to reimburse any interest required to be paid, did not prevent it from being a case where interest must be paid.

In addition to the response already made (p. 69, *supra*), it must be remembered that the United States agree (Art. V, R. 64):

> "The Government shall not negotiate nor demand payment of the note mentioned in the preceding article so long as the contractor is not in default under this agreement."

So there was no obligation under the note until default; and hence, so far as the "advance payment" was concerned the interest was automatically to be reimbursed by the Government.

V. *Right to repay.* The Banks urged that the Butterworth-Judson Co.'s right at any time to repay the advance negatived the idea of trust. The United States was at once the creator and beneficiary of the trust element. It could grant to the other party the right to return the money and terminate the trust relationship.

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* *C. J. 630 et seq.; Morse on Banking,* § 183-186; *Montagu* v. *Pacific Bank,* 81 Fed. 602; *Moreland* v. *Brown,* 86 Fed. 257; *In re Davis,* 119 Fed. 950; *State* v. *Clark,* 4 Ind. 316; *Minard* v. *Watts,* 186 Fed. 245; *In re Franklin Bank,* 1 Paige 249.

VII. That the case is ruled by its decision in *In re Interborough Consolidated Corp.*, 288 F. R. 334.

COMMENT: In fact, both the reasoning and the authorities cited in the *Interborough* opinion, 288 Fed. at p. 347 [9]—351 [18] are strongly in support of the Government's claim of an equitable lien.

But the case is not in point here, because of the great difference in the facts.

The Consolidated deposited about $432,000 in the Empire Trust Co. in an account entitled "Interborough Consolidated Corp. Interest on Interborough Metropolitan 4½% Bonds". It was the custom of the Consolidated, from time to time, shortly before coupons fell due on the bonds of an underlying mortgage of a constituent company [Metropolitan], to withdraw from its general funds sufficient money to meet the coupons and to deposit it in the above account at the Empire Trust Co. The Metropolitan mortgage provided that the interest should be payable at its New York office. As coupons were presented for payment at the Metropolitan's office [Consolidated office], the Consolidated drew a check on the Empire Trust Co. account for the amount of coupons presented; (the check stating on its face that it was to be paid out of the account above mentioned) and handed it to the person presenting the coupons, who cashed the check in the ordinary manner. Similar checks were mailed to registered holders.

The Consolidated went into bankruptcy with $432,000 on deposit. Coupon holders (who had not presented them for payment) sought to have

the fund applied exclusively to the payment of their past due coupons. The trustee in bankruptcy claimed it as general funds of the company.

The Court held that it belonged to the trustee. This was because (1) the Consolidated did not in any way create the Empire Trust as agent or trustee to apply the funds to the payment of coupons; (2) there was no sort of agreement between the Empire trust and/or Consolidated and the coupon holders that any such fund should be created or maintained or that the coupons should be paid therefrom; (3) the account was a purely voluntary one by the Consolidated, over which it retained complete control; (4) the Consolidated could have checked out all or any part thereof for its other uses—without in any way violating any duty or obligation to any one; (5) there was no need to have created the account, which was purely a matter of internal convenience for the Consolidated; (6) and there was no sort of trust imposed on the fund by agreement with anyone.

In the case at bar, by express agreement with the person furnishing the money, the contractor deposited it pursuant to a contract to use it for a specific purpose only, and the Banks accepted the deposit with knowledge of these terms.

The great difference between the two cases is, that, in the *Interborough* case, there was *no* contract between the Consolidated and the coupon holders that *this* fund should be applied to the coupons, nor between the Empire Trust and the coupon holders or the Empire Trust and the Consolidated that *any* fund should be maintained or regarding interest, whereas the Government expressly contracted with Butterworth-Judson Co.

that the fund should be kept separate and applied to a specific purpose, and the Banks took the deposit with knowledge of that contract.

So in *Staten Island Cricket Club* v. *Farmers L. & T. Co.*, 41 App. Div. 321, and *Noyes* v. *First Nat'l Bank*, 180 App. Div. 163, the deposit by a company of funds in a special account in bank, out of which the bank (at the company's request) paid coupons as presented, was held to be a general deposit for the company's use and did not impress any trust on the deposit. But in neither case was the deposit pursuant to any contract between the depositor and a third person (coupon holder or other person) that it should be devoted to that specific purpose and no other. The deposit was for the mere convenience of the company and the bank was merely the company's agent.

On the other hand, in *Rogers Locomotive Wks.* v. *Kelley*, 88 N. Y. 234, a company deposited money in a bank and took a receipt which recited that it was "in trust" to be applied to pay certain coupons and "said money not to be subject to the control of said company otherwise than for the payment of said coupons". It was held that it was a trust fund.

So too, in an earlier case of the *Interborough Consolidated Corp.*, 267 Fed. 914, it was held that where a consolidated corporation declared dividends and set aside in bank the money necessary to pay the dividends on so much of its stock as had not been delivered to stockholders of a constituent company, it became a trust fund for such stockholders, who when they presented their old stock in exchange for new stock were entitled to the accumulated dividends thereon.

CONCLUSION.

The decree should be reversed.

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17 November, 1924.